

Summary of SEC Rules Governing Use of Non-GAAP Financial Measures and Furnishing of Earnings Releases

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I. Introduction

The Securities and Exchange Commission (the "SEC") issued Release No. 33-8176 (the "Release") in which it adopted rules, effective March 28, 2003, concerning the use by reporting companies of financial measures that do not involve the use of United States generally accepted accounting principles ("GAAP"). These measures, which the SEC refers to as "non-GAAP financial measures," are often used by reporting companies to highlight discrete aspects of their financial performance and their use has raised substantial concerns among members of Congress, regulators and investors.

In response to these concerns, and pursuant to Section 401(b) of the Sarbanes-Oxley Act (the "S-O Act"), the SEC adopted two sets of rules. The first, known as Regulation G, involves the public disclosure of non-GAAP financial measures; the second, which involves the use of non-GAAP financial measures in filings made with the SEC, amends Item 10 of Regulation S-K (and for foreign private issuers, amends Form 20-F). While these rules overlap significantly, they also have distinct requirements of which reporting companies must be aware in making any disclosures about operating results and other financial information.

On June 13, 2003, the SEC's Division of Corporation Finance provided its responses to 33 frequently asked questions regarding the use of non-GAAP financial measures (the "FAQs"). This Alert incorporates that guidance as well.

Finally, this Alert addresses Form 8-K amendments that require public companies to furnish on a Form 8-K their earnings releases and similar announcements.

II. Regulation G (Public Disclosure of Non-GAAP Financial Measures)

Section 401(b) of the S-O Act requires the SEC to issue final rules concerning the use of "pro forma financial information" by a reporting company. Regulation G applies to any company that is required to file reports¹ pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, other than a registered investment company. Because the Release uses the term "registrant" for these entities governed by Regulation G (and the other provisions of the Release), we will use that term in this Alert.

A. When Regulation G Applies

1. **Definition of "Non-GAAP Financial Measure":** A registrant must abide by the terms and conditions of Regulation G whenever it, or any person acting on its behalf, publicly discloses or releases material information that includes a non-GAAP financial measure. Regulation G defines a "non-GAAP financial measure" as a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that:

- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most

directly comparable measure calculated and presented in accordance with GAAP in a statement of income, balance sheet or statement of cash flows (or equivalent statements) of the registrant; or

- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure calculated and presented in accordance with GAAP.

The definition of non-GAAP financial measure is expressly intended to capture all measures that have the effect of depicting either a measure of performance or liquidity that is different from that presented in the financial statements computed in accordance with GAAP, or in cash flow or cash flow from operations computed in accordance with GAAP. These differences may arise by use of non-recurring expense or revenue items, such as may be presented in the measures earnings before interest and taxes ("EBIT"), and earnings before interest, taxes, depreciation and amortization ("EBITDA"). EBIT and EBITDA are measures which may be calculated using elements derived from GAAP presentations but not presented in accordance with GAAP.

2. **Exclusions from Definition:** Non-GAAP financial measures do not include operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers, or numbers of advertisers). The term also does not include

ratios or statistical measures that are calculated using exclusively financial measures calculated in accordance with GAAP or required to be disclosed in accordance with or by GAAP. For example, segment information that is presented in accordance with Financial Accounting Standards Board Statement 131, *Disclosures about Segments of an Enterprise and Related Information*, would be a disclosure that is required to be disclosed in accordance with GAAP as the measure reported to the registrant's chief decision maker for purposes of making decisions about allocating resources to the segment and assessing its performance. Such information would not qualify as "non-GAAP financial information" under Regulation G.

The Release further excludes financial measures required by a system of regulation of a government or governmental authority or self-regulatory organization that applies to the registrant. For example, measures of capital or reserves calculated for a regulatory purpose would not be subject to Regulation G.

3. Business Combinations:

One area of specific interest is the application of Regulation G to business combinations. The SEC has specified in the FAQs that written pre-commencement communications required to be filed with the SEC² related to a pending business combination transaction are exempt from Regulation G's reconciliation requirements; however, the exemption does not extend beyond communications that are subject to those rules. Accordingly, non-GAAP financial measures that are disclosed in registration statements, proxy statements or tender offer materials used in business combinations must include the reconciliation to the most directly comparable GAAP financial measure in accordance with Regulation G.

B. Requirements of Regulation G

Regulation G has two requirements: first, a general disclosure requirement, and second, a specific requirement that the registrant reconcile the non-GAAP financial measure to the most directly comparable GAAP financial measure.

1. General Disclosure

Requirement: Regulation G requires that a registrant, or a person acting on its behalf, shall not make public any non-GAAP financial measure that, taken together with the information accompanying that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of a non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. This disclosure requirement mirrors the language of Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Rule 10b-5 thereunder.³

2. Reconciliation Requirement:

Regulation G also contains a reconciliation requirement, which provides that whenever a registrant, or a person acting on its behalf, publicly discloses any material information that includes a non-GAAP financial measure, the registrant must provide the following information as part of the disclosure or release:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- a reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.

The reconciliation must be quantitative for historic measures, and quanti-

tative, to the extent available without unreasonable efforts, for prospective measures.

As an example to the reconciliation requirement, if a registrant wished to present a measure of "free cash flow," namely the amount of cash available after deduction of cash flows for capital expenditures from the GAAP financial measure of cash flows from operating activities, the registrant should provide a clear description of this calculation, as well as the necessary reconciliation to the GAAP measure. Additionally, all material limitations of the measure should be disclosed in order to avoid inappropriate or potentially misleading inferences about its usefulness. In this example, "free cash flow" should not be used in a manner that inappropriately implies that the measure represents the residual cash flow available for discretionary expenditures, since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure. See FAQ No. 13.

If the GAAP financial measure is not accessible on a forward-looking basis, the registrant must disclose that fact and provide reconciling information that is available without an unreasonable effort. In addition, the registrant must identify information that is unavailable and disclose the probable significance of that unavailable information.

C. Operation in Tandem with Regulation FD

Regulation G and Regulation FD are intended to operate in tandem. For example, a "private" communication of material, non-public information to an analyst or a shareholder triggers a requirement to make broad public disclosure of that information under Regulation FD. If that public disclosure contains a non-GAAP financial measure, Regulation G will apply to that disclosure and will require the

registrant to satisfy both the disclosure and reconciliation requirements thereof.

D. Liability Under Regulation G

Regulation G expressly provides that neither the requirements of Regulation G nor a person's compliance or non-compliance with the requirements of Regulation G shall in itself affect any person's liability under Section 10(b) of the Exchange Act or Rule 10b-5 thereunder. The SEC emphasized in the Release, and its staff again emphasized in the FAQs, that materially deficient disclosure made pursuant to Regulation G may, in addition to violating Regulation G, give rise to a violation of such anti-fraud provisions if all the elements for such a violation are present. In the Release, the SEC states, "we continue to be of the view that some disclosures of non-GAAP financial measures could give rise to actions under Rule 10b-5."

In FAQ No. 33, the Division of Corporation Finance staff addressed so-called "voluntary filers" (*i.e.*, registrants no longer subject to the reporting requirements of Section 15(d) of the Exchange Act). The Division of Corporation Finance staff notes:

"It is reasonable that this appearance [of continuing to be required to report to the SEC] would cause shareholders and other market participants to expect and rely on a company's required compliance with the requirements of the federal securities laws applicable to companies reporting under Section 15(d). Accordingly, while Regulation G technically does not apply to a company such the one described in this question, *the failure of such a company to comply with all requirements (including Regulation G) applicable to a Section 15(d)-reporting company can raise significant issues*

regarding that company's compliance with the anti-fraud provisions of the federal securities laws." (Emphasis added)

Finally, it should be noted that Section 3(b) of the S-O Act provides that a violation of the S-O Act or the SEC's rules thereunder shall be treated for all purposes as a violation of the Exchange Act.

E. Foreign Private Issuers

1. *General:* In addition to its application to domestic issuers, Regulation G applies to registrants that are foreign private issuers, subject to limited exceptions. In the case of foreign private issuers whose primary financial statements are prepared in accordance with non-U.S. GAAP principles, Regulation G makes clear that "GAAP" in this instance refers to the principles under which those primary financial statements are prepared. On the other hand, to the extent that a foreign private issuer includes a non-GAAP financial measure derived from or based on a measure calculated in accordance with U.S. GAAP, the SEC has taken the position that GAAP refers to U.S. GAAP for purposes of the application of the requirements of Regulation G to the disclosure of that measure.

2. *Exceptions:* Regulation G does not apply to public disclosure of a non-GAAP financial measure by, or on behalf of, a registrant that is a foreign private issuer if:

- the securities of the foreign private issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with United States GAAP; and
- the disclosure is made by or on behalf of the foreign private

issuer outside the United States, or is included in a written communication that is released by or on behalf of the foreign private issuer outside the United States.

The SEC has determined that the exception outlined above shall continue to apply, notwithstanding the existence of one or all of the following circumstances:

- a written communication is released in the United States as well as outside the United States, so long as the communication is released in the United States contemporaneously with or after the release outside the United States and is not otherwise targeted at persons located in the United States;
- foreign journalists, U.S. journalists or other third parties have access to the information;
- the information appears on one or more websites maintained by the foreign private issuer, so long as the websites, taken together, are not available exclusively to, or targeted at persons located in the United States; or
- following the disclosure or release of the information outside the United States, the information is included in a submission to the SEC made under cover of a Form 6-K.

III. Non-GAAP Financial Measures in Filings with the SEC

In the Release the SEC also adopted amendments to disclosure rules applicable to the use of non-GAAP financial measures in filings with the SEC. As with Regulation G, these amendments do not apply to registered investment companies. The amendments amend Item 10 of Regulation S-K and Item 10 of Regulation S-B. The non-GAAP financial measures provisions in

amended Item 10 of Regulation S-K and Item 10 of Regulation S-B apply to the same categories of non-GAAP financial measures as are covered by Regulation G.

A. Required Disclosures under Amended Item 10

The amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B require registrants using non-GAAP financial measures in filings with the SEC to provide:

- a presentation, with equal or greater prominence than the non-GAAP financial measure, of the most directly comparable financial measure calculated and presented in accordance with GAAP;
- a reconciliation (by schedule or other clearly understandable method), of the differences between the non-GAAP financial measure with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP; this reconciliation must be quantitative for historic measures, and quantitative, to the extent available without unreasonable efforts, for prospective measures;⁴
- a statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operation; and
- to the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not otherwise disclosed.

The first two requirements of amended Item 10 are similar to those of

Regulation G, except that the presentation requirement in amended Item 10 provides that the presentation of the GAAP financial measure be of "equal or greater prominence than the non-GAAP financial measure."

B. Prohibited Disclosures under Amended Item 10

The amended Item 10 has prohibitions on disclosure as well as the mandated disclosures discussed above. These prohibitions include:

- excluding from non-GAAP liquidity measures charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, other than the measures EBIT and EBITDA;
- adjusting a non-GAAP performance measure to eliminate or "smooth" items identified as non-recurring⁵, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;
- presenting non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and
- using titles or descriptions of non-GAAP financial measures that are the same as or confusingly similar to, titles or descriptions used for GAAP financial measures.

C. Elimination of Recurring Items

While there is no *per se* prohibition against removing a recurring item, the registrant must meet the burden of demonstrating the usefulness of any financial measure that excludes recurring items, especially if the measure is used to evaluate performance. Such removals more likely would be permissible if management reasonably believes it is probable that the financial impact of the item will disappear or become immaterial within a near-term finite period. In addition, inclusion of such a measure may be misleading absent the following disclosures:

- the manner in which management uses the non-GAAP measure to conduct or evaluate its business;
- the economic substance behind management's decision to use such a measure;
- the material limitations associated with use of the measure as compared to the use of the most directly comparable GAAP financial measure;
- the manner in which management compensates for these limitations when using the measure; and
- the substantive reasons why management believes the measure provides useful information to investors.

D. Application to Foreign Private Issuers

Additionally, the SEC has also amended Form 20-F to incorporate the newly amended Item 10 of Regulation S-K. Thus, foreign private issuers will be subject to the same requirements as domestic issuers with respect to the use of non-GAAP financial measures in filings with the SEC on Form 20-F. However, a non-GAAP financial measure that would otherwise be prohibited will be

permitted in a Form 20-F filing by a foreign private issuer if the measure is:

- required or expressly permitted⁶ by the standard setter that establishes the generally accepted accounting principles used in the foreign private issuer's primary financial statements; and
- is included in the foreign private issuer's annual report or financial statements used in its home country jurisdiction or market. The SEC intends this exception to only cover situations where the foreign organization affirmatively acts to require or permit the measure, and not situations where the measure is merely not prohibited.

With respect to other SEC filings made by foreign private issuers, the SEC noted that Item 10 of Regulation S-K will not apply to materials submitted to the SEC by foreign private issuers on Form 6-K unless the information in the Form 6-K is incorporated by reference into a registration statement, prospectus or annual report. The SEC further indicated that the requirements of Item 10 of Regulation S-K would not apply to filers on Form 40-F under the Multi-Jurisdictional Disclosure System, but noted that any public disclosure by these filers that is not covered by the exclusion for foreign private issuers would be subject to Regulation G.

IV. Transition Issues

A. How to Reconcile with Prior Periods

As with any new SEC rules, there are significant issues involved with transitioning to a new disclosure format. In the case of Regulation G, a registration statement filed under the Securities Act after March 28, 2003 that incorporates by reference any non-GAAP financial measures

from a previously filed report, even a report that was filed before March 28, 2003, must comply with Regulation G with respect to those non-GAAP financial measures. Reconciliation may be provided in one or more of the following ways:

- amend the previously filed report (with that amendment incorporated by reference into the registration statement);
- include a section within the registration statement that identifies the non-GAAP financial measures that are contained in the incorporated reports and provides the required reconciliation(s); or
- file a current report on Form 8-K or a periodic report that identifies the non-GAAP financial measures that are contained in the incorporated reports and provides the required reconciliation(s) (with that current or periodic report incorporated by reference into the registration statement).

For any periodic report filed with the SEC before March 28, 2003 that is incorporated by reference into a Securities Act registration statement filed after March 28, 2003, only those figures which relate to a fiscal period ending after March 28, 2003 (for example, a projection) are subject to Item 10 of Regulation S-K.

B. Amendments of Prior Filings

Any amendment to a registration statement that is filed after March 28, 2003, where the original registration statement was filed before March 28, 2003, must comply with Regulation G; however, the original filing is not required to comply with Regulation G simply because it has been amended. For example, if a non-GAAP financial measure is included (either directly or through incorporation by reference) in a registration statement that was filed before March 28, 2003 and

an amendment to the registration statement is filed after March 28, 2003, the non-GAAP financial measure is not required to comply with Regulation G. However, a company must consider whether its disclosure is rendered misleading if it does not comply with Regulation G with regard to other non-GAAP financial measures in its original filing, particularly where a non-GAAP financial measure is the same as, or similar to, a non-GAAP financial measure that is in the amendment to the original filing.

C. Web Postings

A company would not be required to remove a document containing a non-GAAP financial measure on its website prior to March 28, 2003. However, if a non-GAAP financial measure that would be subject to Regulation G is added to, amended, revised or updated and posted on the website on or after March 28, 2003, the registrant would have to include the required reconciliation of that measure at that time.

V. New Item 12 of Form 8-K (Earnings Releases)

Acting under its general rulemaking authority but not expressly under the S-O Act, the SEC also adopted an amendment to Form 8-K to add new Item 12, "Disclosure of Results of Operations and Financial Condition." New Item 12 does not require that companies issue their earnings releases or similar announcements. However, such releases and announcements will trigger the requirements of Item 12.

A. General Requirements

Item 12 requires registrants to furnish (as opposed to file)⁷ the SEC with a Form 8-K within five business days of any public announcement or release disclosing material non-public information regarding a registrant's results of operations or financial condition for an annual or quarterly fiscal

period that has ended. The requirements of Item 12 apply regardless of whether the release or announcement includes disclosure of a non-GAAP financial measure. Repetition of information that was publicly disclosed previously or the release of the same information in a different form would not trigger the Item 12 requirement. However, release of additional or updated material non-public information regarding the registrant's results of operations or financial condition for a completed fiscal year or quarter would trigger an additional Item 12 obligation.

B. Exceptions to Furnishing Requirements

Item 12 includes an exception from its requirements where non-public information is disclosed orally, telephonically, by webcast, by broadcast, or by similar means in a presentation that is complimentary to, and occurs within 48 hours after, a related, written release or announcement that triggers the requirements of Item 12. Item 12 would not require the registrant to furnish an additional Form 8-K with regard to the information that is disclosed by such means if:

- the related, written release or announcement has been furnished to the SEC on Form 8-K pursuant to Item 12 prior to the presentation;
- the presentation is broadly accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is provided on the registrant's website at the time the oral presentation is made⁸, together with any information that would be required under Regulation G, either in audio or written form so long as it can be accessed by investors through the website; and

- the presentation was announced by a widely-disseminated press release that included instructions as to when and how to access the presentation and a location on a registrant's website where the information will be available.

Note that Item 12 of Form 8-K will apply only to publicly disclosed or released material non-public information concerning an annual or quarterly fiscal period that has ended. Item 12 will not apply to public disclosure of earnings estimates for future or ongoing fiscal periods, unless those estimates are included in the public announcement or release of material non-public information regarding an annual or quarterly fiscal period that has ended.

C. Significance of Information "Furnished" to SEC

Note that the SEC amended its original proposed amendment to expressly provide that earnings releases or similar disclosures under Item 12 of Form 8-K be furnished to the SEC rather than filed. The significance of this amendment in the final release is:

- Information furnished to the SEC is not subject to the anti-fraud provisions of Section 18 of the Exchange Act;
- Information furnished to the SEC is not incorporated by reference into a registration statement, proxy statement or other report;
- Information furnished to the SEC, if not timely filed, does not cause the registrant to be ineligible for use of Form S-3 for failure to meet the timely filing requirements;
- Information furnished to the SEC is not subject to the requirements of amended Item 10 of Regulation S-K or Item 10 of Regulation S-B.

D. Application of Regulation G to Earnings Releases

Regulation G would apply to earnings releases and similar disclosures made under Item 12 of Form 8-K. In addition to the requirements imposed by Regulation G, registrants are required to disclose:

- the reasons why the registrant's management believes that presentation of a non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and
- to the extent material, the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not otherwise disclosed.

E. Relationship of Item 12 to Regulation FD

The Release provides that earnings releases and similar disclosures that trigger the requirements of Item 12 are also subject to Regulation FD. An earnings release must be furnished under Item 12 of Form 8-K whereas Regulation FD provides that a Form 8-K filing is only one means of satisfying its requirements. A Form 8-K furnished within a time frame required by Regulation FD and otherwise satisfying the requirements of both Item 9 and Item 12 could be furnished to the SEC once, indicating that it is being furnished under both Item 9 and Item 12, and satisfy both requirements.

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¹ While technically Regulation G applies only to entities that are required to file such reports, the failure of so-called “voluntary filers” to comply with all the requirements (including Regulation G) applicable to a reporting company can raise significant issues with respect to the anti-fraud provisions of the federal securities laws. See “Liability Under Regulation G” below.

² These pre-commencement communication rules are Rule 425 (for registration statements), Rule 14a-12 (for proxy statements) and Rule 14d-2(b)(2) (for tender offers).

³ As discussed below under “Liability under Regulation G,” however, a registrant could independently be subject to liability under Section 10(b) of the Exchange Act and Rule 10b-5 if all the elements for such a violation are present.

⁴ See discussion under “Requirements of Regulation G: Reconciliation Requirements” above for an example of a reconciliation of “free cash flow” to GAAP.

⁵ When contemplating the label of charges as recurring or non-recurring, according to the FAQs management should consider the substantive nature of the item. If there is a past pattern of restructuring charges, no articulated demonstration that these charges will not continue and no other unusual reason that a company can substantiate to identify the special nature of the restructuring charges, it would be difficult for a company to meet the burden of disclosing why such a non-GAAP financial measure is useful to investors.

⁶ A measure is expressly permitted if the particular measure is clearly and specifically identified as an acceptable measure by the standard setter that establishes the GAAP used in the registrant’s primary financial statements included in its filing with the SEC.

⁷ See discussion below under “Significance of Information ‘Furnished’ to the SEC” for the importance of the distinction between “furnishing” and “filing.”

⁸ In the case of an unexpected disclosure in connection with the question and answer session that was part of the oral presentation, the information must be posted on the registrant’s website promptly after it is disclosed.

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